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Planning and Drafting Nonqualified Deferred Compensation Arrangements

William A. Hancock

In fully analyzing nonqualified deferred compensation arrangements, Mr. Hancock provides a useful aid for those engaged in the art of business planning. The author begins by setting forth the advantages and disadvantages of such arrangements and proceeds to an evaluation of the relevant factors to be examined when considering a specific plan. Tax incidents to both the employer and selected employee are emphasized by the author, who discusses the pertinent case law, Treasury regulations, and revenue rulings. The proper ingredients for precisely drafting the necessary documents, such as the methods for computing the amounts to be paid, the methods of actual payment, and the conditions which should be included, are presented by Mr. Hancock as the final segment of his comprehensive analysis.

I. INTRODUCTION

IN A DEFERRED compensation arrangement an employee agrees to work for a current compensation of less than his services could otherwise command, and, in return, his employer agrees to pay him additional amounts in the future, usually after retirement.¹ If used properly, the principal advantage of the arrangement lies in its potential income tax savings. For example, if an executive is receiving current compensation which puts him in the 70 percent income tax bracket, he obtains little after tax gain by receiving any more current taxable income. On the other hand, if the executive can arrange to have a portion of his compensation paid to him after retirement when his

THE AUTHOR: WILLIAM A. HANCOCK (B.S., Tulane University; J.D., Western Reserve University) is a practicing attorney in Cleveland, Ohio and a member of the Cleveland, Ohio State, and American Bar Associations.

¹ For a general discussion of deferred compensation agreements, see 7 Z. CAVITCH, BUSINESS ORGANIZATIONS ch. 135 (1967); 20-2d TAX MANAGEMENT PORTFOLIO *Deferred Compensation Arrangements* [hereinafter cited as T.M. PORTFOLIO]; 1 G.T. WASHINGTON & V. ROTHSCHILD, COMPENSATING THE CORPORATE EXECUTIVE chs. 5-6 (3d ed. 1962). See generally Durkin, *Non-Qualified Compensation Plans*, 29 U. CIN. L. REV. 68 (1960); Lindquist, *Fundamentals of Deferred Compensation*, 43 ILL. B.J. 756 (1955); McCaffrey, *A Case of Executive Deferred Compensation*, 13 J. AM. SOC'Y C.L.U. 120 (1959); Nolan, *Deferred Compensation Planning: Special Situations for Individuals in Large and Small Corporations*, N.Y.U. 23D INST. ON FED. TAX. 217 (1965); Weisbard, *Executives Compensation Package Can Have Many Benefits, Save Him Much Money*, 10 J. TAXATION 54 (1959).

tax bracket will be much lower, a substantial tax savings might result.

This article is designed to aid the practitioner: (1) to analyze particular situations to ascertain whether a deferred compensation arrangement can be advantageously used;² (2) to decide on a particular type of arrangement which would be most suitable for the client and obtain the maximum tax advantages for both the employer and the executive, and would avoid miscellaneous problems which are sometimes created by deferred compensation arrangements; (3) to draft the appropriate documents.

II. IS A DEFERRED COMPENSATION PLAN ADVISABLE?

Initially, it should be emphasized that deferred compensation arrangements should be an integrated part of an overall compensation scheme and must be considered together with all other forms of compensation. Before contemplating nonqualified deferred compensation arrangements, it should be determined that current compensation is adequate, and that the more traditional fringe benefits are not being overlooked. If such fringe benefits as qualified pension, profit sharing, or stock option plans already exist, deferred compensation arrangements should be considered together with them.³

² As used herein, deferred compensation *arrangement* refers only to a nonqualified arrangement. Generally, a deferred compensation *plan* refers to a single agreement between a single employer and more than one employee and a deferred compensation *contract* or *agreement* refers to an agreement covering only one executive. As used herein, deferred compensation *arrangement* means either a plan or a contract, or both. The tax laws draw no distinction between nonqualified deferred compensation plans or contracts. However, see 1 G.T. WASHINGTON & V. ROTHCHILD, *supra* note 1, at 149 for some important implications of a deferred compensation *plan*.

³ For a discussion of the means and ends of employee compensation, see E. WOOD, J. CERNY & H. RAFUSE, *TAX ASPECTS OF DEFERRED COMPENSATION* 1 (1966). Lynch, *Something About Deferred Compensation*, 12 J. AM. SOC'Y C.L.U. 305 (1958), contains a good discussion of when to use a deferred compensation arrangement, how it compares with a regular savings program, and what types of insurance can be used in connection with the program. For an interesting discussion of the deferred compensation plans of Ford Motor Company, duPont, and Consolidation Coal Company, see Bergen, *Deferred Compensation*, N.Y.U. 17TH INST. ON FED. TAX. 879 (1959).

Some basic considerations which must be made by the corporation in deciding on the type of arrangement most beneficial to it are:

- (1) whether the additional compensation to be paid is to be paid currently or to be paid in the future, after retirement;
- (2) whether the additional compensation is to be in the form of cash or stock of the company;
- (3) whether the arrangement is to benefit only selected key employees, or whether it is to benefit all employees, or substantially all employees;

Some of the possible advantages and disadvantages of a non-qualified deferred compensation arrangement are as follows:⁴

A. Possible Advantages

(1) Income tax savings might result by using such an arrangement.

(2) Nonqualified deferred compensation arrangements are extremely flexible, can be very simple, and can be used to compensate one selected employee or a group of selected employees. Also, by definition, nonqualified arrangements are not subject to the numerous and complex rules pertaining to qualified plans.

(3) If the deferred compensation agreement takes the form of a mere promise by the corporation to pay additional compensation in the future, the corporation will have the funds it would have allocated for the current compensation available to finance its other operations, until they are actually paid.

(4) A deferred compensation arrangement can assist the employer in accelerating retirement of older executives, thereby helping to entice younger men who can be assured that vacancies in higher positions will become available.

(5) A deferred compensation arrangement provides a certain amount of retirement security for the employee.

(6) The arrangement can serve to reduce executive turnover, since the payments are usually forfeitable in the event of premature resignation.

(7) There is little or no administration expense in the usual nonqualified arrangement as opposed to the considerable expenses involved in the establishment and administration of any qualified plan.

B. Possible Disadvantages

(1) Nonqualified arrangements do not have the special tax advantages of qualified plans, such as the possibility of obtaining capital gain treatment, because under a nonqualified plan the payments are ordinary income to the executive when received, whether in the form of cash, the employer's stock, or other property. Also,

(4) whether the arrangement is to be paid for entirely by the company or whether it will allow employee participation; and

(5) whether the plan will involve the establishment of a separate fund, or merely involve the general obligations of the company.

⁴ For additional discussion of these, see the sources cited in note 1 *supra*.

no tax-free earnings can accumulate in a fund, as is possible under a qualified plan.

(2) Benefits passing to those who survive the employee will be subject to an estate tax in almost all instances, and the \$5,000 death benefit income tax exclusion is not available in certain kinds of deferred compensation arrangements.⁵

(3) The employee may prefer to have the current cash on the theory that "a bird in the hand is worth two in the bush."

(4) The employer's deduction is deferred.

(5) Since the employer's deduction will be deferred, it may fall in a year in which there are no profits or insufficient profits against which to offset the deduction.

(6) A deferred compensation arrangement may involve a risk to the employee of noncollection of the deferred amounts.

(7) The employee might react adversely to the usual provision that his deferred compensation will be forfeited if he leaves the company before retirement.

(8) There might be some accounting problems and the company balance sheet may have to reflect a larger liability than anticipated.⁶

⁵ See discussion note 100 *infra* & accompanying text.

⁶ Opinion No. 12, of the Accounting Principles Board provides in substance that if an employee is to be paid deferred compensation after he retires, it should be accrued during the employee's period of active employment. To illustrate by an exceedingly oversimplified example, in which no attempt has been made to take into account the effects of interest, if an employee age 60 is awarded a deferred compensation contract in which he agrees to work for \$40,000 per year current compensation until age 65 at which time he would retire and receive \$20,000 per year deferred compensation for the next 5 years until age 70, then the company should accrue on its books \$60,000 per year during his active employment with the company so that, at the end of the period of active employment, it would have accrued on its books a liability for \$100,000 of compensation. As the \$100,000 is actually paid to the employee, this liability would be reduced. On the other hand, if the employee's period of active employment can be said to extend reasonably beyond his retirement into the period in which he is receiving deferred compensation, because the services which he is to render after retirement are reasonably proportionate to the value which he is receiving under the contract, then there is no need to accrue the deferred compensation on the books of the company before retirement. If a deferred compensation contract calls for services to be rendered after retirement, these services must be valued at *the time the contract is made*. This is obviously going to cause some practical difficulty. In the above example, if at the time the contract was made it was agreed that consultative services were going to be rendered and that they were, in fact, worth \$20,000 to the company, then no rapid accruals would be necessary. If, however, it were determined that these conditions were placed in the contract merely on the advice of counsel and had no substantive effect, then they would be disregarded for accounting purposes and the company would accrue the total amount of compensation during the period of active employment. Of course, there are many possibilities in between these examples. If it were determined that the services to be performed would be worth \$10,000 per year, then the company would accrue only \$10,000 per year during the period of active employment to make up for the difference. If the company has a

(9) Last, but perhaps most important, considered under all of the facts, the plan may result in an overall net economic loss to the employee it was designed to benefit.

This latter problem makes it necessary to analyze each proposed deferred compensation arrangement, considering each of the factors listed below, to ascertain how much, if any, net economic gain will be achieved by a plan. Many times the results of a complete analysis show an extremely small net gain, or even a net economic loss. The following are some of the factors which should be considered in evaluating a proposed arrangement from a purely financial standpoint.⁷

C. Financial Factors

(1) *Progressive Income Tax Rates.* —Although our present income tax rates are progressive, it is important to note that the progression decreases in the higher income tax brackets. For example, the brackets increase from about 22 percent at \$4,000 taxable income to about 58 percent at \$44,000 taxable income, an increase of 36 percent. But, they only increase to 68 percent at \$84,000, an increase of 36 percent in the \$40,000 between \$4,000 and \$44,000 and an increase of only 10 percent for the \$40,000 between \$44,000 and \$84,000.⁸ The obvious effect is that the higher the executive's current compensation, the smaller will be the *relative* tax savings to be achieved by deferring part of it.

(2) *Effect on Other Benefits Received by the Employee.* —Many typical *qualified* pension and profit sharing plans base their benefits on the participant's current compensation. Therefore, if the participant's current compensation is only a part of his total compensation, he receives less under these qualified plans than he would have received if all of his compensation had been paid currently.

(3) *Loss of Investment Yield.* —If the executive is paid the

number of deferred compensation plans requiring rapid accrual of deferred amounts, the balance sheet might have to reflect a considerable liability, making the plans substantially less attractive. (It should be noted that Opinion No. 8 of the Accounting Principles Board provides, in effect, that if all of the deferred compensation contracts taken together are equivalent to a pension plan, then the new accounting rules contained in that Bulletin involving accounting for the costs of pension plans shall be followed.) AICPA ACCT'G PRINCIPLES BD., OPINION NO. 12 (1967).

⁷ For additional discussion of how to make this evaluation, see Gemmill, *Deferral of Compensation Frequently Results in Overall Economic Loss*, 19 J. TAXATION 276 (1963).

⁸ INT. REV. CODE OF 1954, § 1 [hereinafter cited as CODE].

compensation currently, he would be able to invest the after-tax increase and obtain a yield on the investment. While the yield would also be subject to tax, most of it would probably be at the capital gain rate and there would still be a substantial net yield to the executive. By deferring the compensation, the investment yield would be lost to some extent, depending upon how long the payments are deferred, the particular executive's ability to invest, and his after-tax investment yield.

(4) *Inflation.* —The establishment of a fixed amount of cash on the basis of today's dollars, to be paid later in dollars worth substantially less because of inflation, has an obvious disadvantage to the executive. The amount of this loss will depend upon how the inflation spiral progresses and upon how long the payments are deferred.⁹

(5) *Employee's Other Income.* —If the employee will have substantial other *taxable* income after retirement, as from annuity policies or investment yields, the savings from deferring current income will be decreased.¹⁰

It should be pointed out that the above observations are based on the hypothesis that the deferred amount will be exactly the same as the amount which the corporation would be willing to pay currently. This may not be true because, since the corporation's payments will be deferred, it might be willing to pay more deferred compensation than current compensation. This is partly due to the effects of interest, earnings, and inflation, and partly due to the general optimism of most businessmen that the corporation will be able to afford more compensation in the future than it can in the present.

In summary, no deferred compensation plan should be suggested by the company until its total compensation picture has been analyzed and found to be adequate in terms of present compensation and traditional fringe benefits, and until the various types of tax-favored qualified plans have been investigated. Further, the executive should not suggest or accept a plan until his particular situation has been analyzed and the net economic effect of a deferral of part of his compensation has been determined.

⁹ Inflation is sometimes estimated to be about 3 percent per year.

¹⁰ In computing the potential tax savings, consideration should be given to the extra exemption allowed persons 65 years of age and older. CODE § 151(c).

III. TYPES OF ARRANGEMENTS — TAX CONSIDERATIONS

While there are many nontax aspects to nonqualified deferred compensation arrangements, in many, if not most situations, tax considerations will dictate both the advisability of having such an arrangement and much of its content. Basically, four tax related objectives can and should be achieved by a deferred compensation arrangement:¹¹

(1) obtaining a deduction for the employer for the deferred amounts, at least when payments are actually made;

(2) achieving maximum assurance for the employee that he will, in fact, receive the deferred amounts;

(3) preventing the deferred amounts from being taxed to the employee before they are actually received;¹²

(4) assuring both the employer and the employee that no other disadvantages will be created by the plan or by distributions made pursuant to the plan.

Objectives one and three will be accomplished by almost any formbook plan.¹³ However, to achieve maximum effectiveness most situations will require at least a slight alteration of the basic formbook plan, and generally the situation will require almost total original drafting.¹⁴ It is therefore essential that the draftsman be cognizant of the applicable tax rules so that no objective is inadvertently lost. Each of the above objectives will be discussed in turn.

A. Obtaining a Deduction for the Employer for the Deferred Amounts at Least When Payments Are Actually Made

An arrangement which requires payments to be made as compensation but does not allow a corresponding deduction at any time is entirely unsatisfactory. Further, an arrangement which requires an accrual of what ordinarily would be a deductible expense in one year, but precludes a deduction until some years later when the

¹¹ The first three are examined in Stuetzer, *Deferred Compensation Contracts: Individual Contracts: Non-qualified General Plans*, N.Y.U. 21ST INST. ON FED. TAX, 479 (1963). Hoffman, *Tax Influences in Shaping the Executive Pay Package*, 40 TAXES 386, 394 (1962), contains an interesting chart showing tax implications of all forms of supplementary compensation.

¹² Stuetzer, *supra* note 11, at 480.

¹³ See 5 J. RABKIN & M. JOHNSON, CURRENT LEGAL FORMS ch. 12 (1967).

¹⁴ Since one of the advantages of a nonqualified plan is that it is extremely flexible, formbooks should be used only for ideas and as a checklist.

payments are actually made is not very attractive, but the employer eventually does get the deduction, and if there is a corresponding tax advantage to a key employee, the employer may consent to the arrangement. The arrangement must be properly planned so that the deduction is not permanently lost.

The basis of the problem is that, unlike *current* compensation of employees which is deductible under section 162 as a business expense, or under section 212 as a related nonbusiness expense, *deferred* compensation is deductible, if at all, under section 404 of the *Internal Revenue Code*, and then only if the requirements of section 162, or section 212, are satisfied.¹⁵ Section 404 and the regulations thereunder provide in substance that the employer is entitled to a deduction for deferred compensation only when the compensation is *actually paid*, and only if the employee's rights to the compensation or contribution are *nonforfeitable*. In order to more fully understand these requirements, it is necessary to discuss the concepts of *funding* and *forfeitability*.

A funded plan is one which is financed by contributions to a trust, to escrow arrangements, to the purchase of insurance or an annuity contract, or in any similar manner where the employee has a direct legally enforceable interest in a res which purports to be insulated from the claims of general creditors of the corporation. An unfunded plan is one in which the employee has no direct legally enforceable interest in any such res; rather, he depends entirely upon the unsecured promise of the corporation to make the deferred payments.¹⁶

The concept of forfeitability refers to whether an employee's rights to either money deposited in a fund or payments to be made by the corporation are *conditioned* and forfeitable in any way. Many deferred compensation contracts contain provisions to the effect that the employee will receive the deferred compensation

¹⁵ CODE § 404(a); see Times Publishing Co., 13 T.C. 329 (1949), *aff'd per curiam*, 184 F.2d 376 (3d Cir. 1950). This, of course, applies only to deferrals of compensation contemplated by section 404 and does not apply to bonuses based on profits for the current year which are paid as soon after the end of the year as the figures are determined. See Knight, *Income Tax Consequences of Non-qualified Deferred Compensation*, 1 TAX LAW. 163 (fall 1967).

¹⁶ Neither the *Code* nor the regulations define the word "funded." A functional definition appearing in Stuetzer, *supra* note 11, at 481, reads as follows:

A funded non-qualified deferred compensation arrangement is one in which the employer makes contributions to a non-exempt trust, purchases for an employee a non-qualified annuity, or makes payments of any kind, so that, if the executive's rights therein were nonforfeitable, taxable income to the executive would result by virtue of the statute, constructive receipt, or economic benefit.

only upon certain conditions, usually having to do with staying with the company for a certain period of time, rendering consultative services after retirement, or refraining from entering into competition with the company after retirement. In such a situation, the employee's rights would be forfeitable because if he did not satisfy any of the conditions, he would lose his rights to the additional compensation.¹⁷

Once the concepts of funding and forfeitability are understood, the tax rules are quite simple to state. Section 404 provides that the deduction may be taken "[i]n the taxable year *when paid* . . . if the employee's rights to or derived from such employer's contribution or such compensation are *non-forfeitable at the time the contribution or compensation is paid*."¹⁸ It is thus clear that if the arrangement is *unfunded*, the employer will be entitled to a deduction only when the compensation is actually paid whether or not the employee's rights are forfeitable.¹⁹

If the plan is funded, the employer may deduct his contribution when it is paid *if* the employee's rights are *nonforfeitable*. However, if the employee's rights are *forfeitable*, a Treasury regulation provides that the employer will *never* get a deduction, even when the funds are actually paid to the employee. This possibly invalid²⁰ regulation provides as follows: "If an amount is paid during the taxable year to a trust or under a plan and the employee's rights to such amounts are forfeitable at the time the amount is paid, no deduction is allowable for such amount *for any taxable year*."²¹

The rule is both harsh and illogical. The Court of Claims would seem to be correct in allowing the deduction when payments are in fact made to the employee on the theory that the trustee or escrow agent, for example, made the payments as agent for the

¹⁷ See Treas. Reg. § 1-402(b)-1(a)(2)i (1956), T.D. 6783, 1965-1 CUM. BULL. 180.

¹⁸ CODE § 404(a)(5) (emphasis added).

¹⁹ See Treas. Reg. § 1.404(a)-12 (1956); Rev. Rul. 60-31, 1960-1 CUM. BULL. 174; Knight, *supra* note 15, at 187; 20-2d T.M. PORTFOLIO, *supra* note 1, at A23-24. Rev. Rul. 55-212, 1955-1 CUM. BULL. 299, points out that the deduction must be taken when the compensation is paid even though the employer uses the accrual method of accounting and the employee's rights are nonforfeitable. Although the ruling involved the 1939 Code, its principle is still valid.

²⁰ See *Buttrey Stores, Inc. v. United States*, 375 F.2d 799 (Ct. Cl. 1967); *Mississippi River Fuel Corp. v. United States*, 314 F.2d 953 (Ct. Cl. 1963); *Russell Mfg. Co., v. United States*, 175 F. Supp. 159 (Ct. Cl. 1959), *nonacquiesced in*, Rev. Rul. 59-383, 1959-2 CUM. BULL. 456-57. See also *United States v. Russell Mfg. Co.*, 349 F.2d 13 (2d Cir. 1965) (concurring opinion).

²¹ Treas. Reg. § 1.404(a)-12 (1956) (emphasis added).

employer.²² However, many courts reach the result called for by the Treasury regulation and hold that the deduction is completely lost.²³ It would therefore seem that this must be taken as the rule unless the employer is willing to go to litigation in the Court of Claims.

In summary, objective number one will be satisfied if a plan does *not* provide for *funding* and does not make the employee's rights in the fund *forfeitable*.²⁴

B. Achieving for the Employee the Maximum Assurance That He Will in Fact Receive the Deferred Amount

If the employee is to consider a plan valuable, he must be reasonably confident that he will actually receive the deferred amounts. In a large, widely held corporation, this will rarely present a problem. However, in a smaller, closely held corporation, the employee may feel that the uncertainty of collecting on the unsecured promise of the corporation to pay the deferred amount outweighs the other advantages of the plan.²⁵ There are various ways to give the employee somewhat more than the mere unsecured promise of the corporation without going so far as to fund the arrangement and incur all of the disadvantages which funding entails.²⁶

Initially, it must be pointed out that the concept of funding has no application where the employer merely sets aside money for a known future obligation and does not try to give the employee an interest in those funds or to insulate them from the claims of the

²² Cases cited note 20 *supra*.

²³ See *Wesley Heat Treating Co. v. Commissioner*, 267 F.2d 853 (7th Cir. 1959); *Shalite Corp. v. United States*, 67-1 U.S. Tax Cas. ¶ 9257 (E.D. Tenn. 1967); *Mississippi River Fuel Corp.*, 29 T.C. 1248 (1958), and *Mississippi River Fuel Corp. v. Kohler*, 164 F. Supp. 844 (E.D. Mo. 1958), *both aff'd*, 266 F.2d 190 (8th Cir. 1959), *cert. denied*, 361 U.S. 827 (1959); *Times Publishing Co.*, 13 T.C. 329 (1949), *aff'd per curiam*, 184 F.2d 376 (3d Cir. 1950).

²⁴ See the discussion of collateralized funding in text accompanying note 35 *infra*.

²⁵ This is not to say that the executive does not trust the management. In small closely held corporations, the executive is probably more concerned with such possibilities as overall economic declines affecting the company, or death of the present majority shareholders or chief executive officer of the corporation rather than with the honesty of the present management.

²⁶ See discussion in text accompanying note 35 *infra* for a somewhat controversial way of doing this.

Funding will almost always preclude one of the desired objectives. If the employee's rights are forfeitable, the employer may lose the deduction and if the employee's rights are nonforfeitable, then the payments to the fund may constitute an economic benefit to the employee, resulting in immediate taxation.

general corporate creditors. Thus, the employer which incurs a liability each year as the services are rendered may choose to set aside cash or to make investments in securities, insurance, or annuity contracts so that sufficient funds will be available to pay the deferred compensation amounts when they become due. If the employer, and not the employee, is the beneficiary of such an arrangement, the employee will not be taxed prior to receiving payments.²⁷ Thus, the executive can in fact be given reasonable assurances that the corporation will finance its obligation to him by the means above indicated, without causing immediate taxation to the employee or causing the employer to permanently lose the deduction.²⁸

One method by which the company could finance a deferred compensation arrangement without any adverse tax effects involves the use of a commercial annuity. Under this method, the corporation would purchase a life insurance contract, convertible to an annuity, on the life of the executive, with the policy being "*owned by and payable to the corporation.*"²⁹ When the employee reaches the designated retirement age, the life insurance policy would be converted into an annuity. Although part of the annuity payments would be taxed to the corporation,³⁰ the corporation would be allowed a deduction for the amounts paid to the employee.³¹ Therefore, the annuity, along with the tax savings achieved by the deduction, would provide the requisite amount to fulfill the contractual obligation.³²

Since the corporation will obtain an income tax deduction when the deferred compensation is paid, there is no need to set aside the entire amount of deferred compensation earned in any given year. For example, if the total annual amount to be deferred is \$10,000, the corporation can annually credit to the reserve

²⁷ *Casale v. Commissioner*, 247 F.2d 440 (2d Cir. 1957); Rev. Rul. 59-79, 1959-1 CUM. BULL. 15.

²⁸ The arrangement can also provide for periodic information reports to be given to the executive for assurance that adequate financial arrangements can be made. But it is important for the corporation to make certain that such reports contain only information and contain nothing which would give the executive a legally enforceable right to any fund or insurance or annuity contract before payments are to be made.

²⁹ Stuetzer, *supra* note 11, at 489.

³⁰ CODE § 72(a).

³¹ *Id.* § 404.

³² The arrangement can be designed to provide an element of indemnification to the company in the event of the untimely death of the executive. For a more detailed discussion, see 17 J. TAXATION 229, 230 (1962).

\$5,200.³³ When the payment is later made to the employee, the reserve can be charged \$5,200 and that year's provision for taxes can be charged \$4,800. Of course, the adequacy of the fund created by this arrangement depends upon the corporation having profits in the year of payment against which to match the deduction.³⁴

To complete this discussion, the concept of "collateralized funding" must be mentioned. This concept refers to an arrangement in which the employer enters into a contract obligating itself to pay deferred compensation and then arranges with a third party, most often an insurance company, to guarantee payment to the employee in the event that the employer fails to pay. Its obvious advantage is that it gives almost positive assurance to the employee that he will in fact receive the payments, but a difference of opinion exists as to whether this procedure has any tax dangers.³⁵

To summarize, if the objective of providing maximum assurance to the employee is to be accomplished by creating a fund for his benefit in which he has legally enforceable rights and which purports to be insulated from the claims of corporate creditors, then the employee will lose the objective of being taxed only when deferred compensation is received. Furthermore, if the employee's rights in the fund are in any way forfeitable, then the employer's deduction will be permanently lost. Nevertheless, there are a number of sound ways to give the employee additional assurances that the money will be paid to him without incurring any corresponding tax detriment. Basically these methods comprehend sound financing by the corporation either through insurance, private investment, securities, or stock of the corporation itself. In addition, there are some ways to give the employee almost absolute assurances that he will receive the deferred compensation, but these methods are relatively untried and extreme caution should be exercised in their use.

C. Assuring the Employee That the Deferred Amounts Will Be Taxable Income to Him No Earlier Than When They Are Received

Having formulated a plan which assures the employer that it

³³ A 48 percent tax rate is assumed.

³⁴ Stuetzer, *supra* note 11, at 489.

³⁵ Collateralized funding is discussed in detail in Rivers, *Collateralized Deferred Compensation — Poison or Panacea*, 20 J. AM. SOC'Y C.L.U. 37 (1966), wherein the author concludes that the arrangement will accomplish objective number 2 with little or no adverse tax consequences. For a contrary opinion, see 20-2d T.M. PORTFOLIO, *supra*

will receive a deduction for the payments of the deferred portion of the compensation, at least when they are made, and which assures the employee, to the maximum extent reasonably possible, that he will receive the deferred portion of his compensation, it will probably be essential to assure the employee that the deferred compensation will not be taxed to him before it is actually received. This is probably the most complicated part of the problem and the area where most of the cases have arisen and where most of the writing has been done. Basically, the Internal Revenue Service has two principal theories on which to base an assertion that the employee has received taxable income before he actually receives the cash: the *constructive receipt* theory and the *economic benefit* theory.³⁶

note 1, at A4. See also Rivers, *Deferred Compensation Contracts*, 103 TRUSTS & ESTATES 57 (1964), for an earlier discussion of collateralized arrangements.

³⁶ While constructive receipt and economic benefit are the two principal theories on which the IRS relies, usually asserting them in the alternative as in *George W. Drysdale*, 32 T.C. 378 (1959), *rev'd & remanded*, 277 F.2d 413 (6th Cir. 1960), variations on the two principal theories and other separate theories are also employed. Further, one theory is sometimes called by two different names. For instance, the economic benefit doctrine is sometimes called the "cash equivalent doctrine" and the constructive receipt doctrine is sometimes called the "deferral of previously earned income doctrine."

A theory which arises in the context of boxing promotion contracts is the joint venture theory. Example 5 of Rev. Rul. 60-31, 1960-1 CUM. BULL. 174, discusses this theory and it was recently litigated in *Ray S. Robinson*, 44 T.C. 20 (1965), involving the contract which was made for the Sugar Ray Robinson-Carmen Basilio fight. It is unlikely that the joint venture theory will cause any problem in the usual deferred compensation agreement involving a corporation and an executive-employee. See *Delson & Broser, Sugar Ray's Deferred Pay Contract Holds Door Open for Earnings Postponement*, 23 J. TAXATION 80 (1965).

The assignment of income doctrine is generally used to determine *who* receives income rather than *what* is income (the economic benefit doctrine) or *when* income is received (the constructive receipt doctrine). Sometimes the doctrines are confused as illustrated by two commentators analyzing the same case and each applying a different theory. *Hicks v. United States*, 314 F.2d 180 (4th Cir. 1963), is a good example. *Rothschild & Ness, IRS Confines Hicks Case and Sanctions Deferred Compensation Choices*, 19 J. TAXATION 216 (1963), treats this case as dealing with constructive receipt, while Mr. Knight, the author of T.M. PORTFOLIO, *supra* note 1, who also wrote the *Tax Lawyer* article cited in note 15 *supra*, treats *Hicks* under the assignment of income concepts. The *Hicks* case involved a qualified profit sharing plan of a bank which provided, in effect, that if the employee gave prior written direction to the employer in each year, the whole of the employee's share of the annual profit sharing contribution would be paid into the profit sharing plan for the account of the employee, but if the employee did not give such prior written notice to the employer, only 40 percent of his share of the annual contribution would be paid into the trust and the remaining 60 percent would be paid to the employee in cash. Mr. Hicks gave prior timely notice to have 60 percent of his share put into the plan. The employer did so and Mr. Hicks reported his income for that year without including the amount put into the plan. The Commissioner assessed a deficiency and the Fourth Circuit Court of Appeals held that Mr. Hicks had *constructively received* the income and it was therefore taxable to him. Essentially, the court reasoned that the bank had paid the contribution to itself as trustee upon the direction of Mr. Hicks and relied on some traditional assignment of income cases, e.g., *Helvering v. Horst*, 311 U.S. 112 (1940); *Lucas v. Earl*, 281 U.S. 111 (1930). 314

The doctrine of constructive receipt is properly applicable to determine *when* an item of income is sufficiently realized so that it may be taxed to a cash basis taxpayer.³⁷

The basis for the doctrine is found in the following language of the regulations:

Gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting.³⁸

Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time³⁹

Generally, under the cash receipts and disbursements method in the computation of taxable income, all items which constitute gross income (whether in the form of cash, property, or services) are to be included for the taxable year in which actually or constructively received.⁴⁰

The following is an often quoted statement of the doctrine:

It is clear that the doctrine of constructive receipt is to be spar-

F.2d at 183-85. The *Hicks* case could have been disturbing because of some of the language used, but subsequently Rev. Rul. 63-180, 1963-2 CUM. BULL. 189, confined the case to its special facts and it is therefore not significant in the nonqualified deferred compensation area. See also 39 N.Y.U.L. REV. 328 (1964).

The case of *Llewellyn v. Commissioner*, 295 F.2d 649 (7th Cir. 1961), is an assignment of income case usually mentioned in connection with *Hicks*. In the *Llewellyn* case, the taxpayer was a pathologist who had a contract with a hospital under which he received a percentage of certain laboratory receipts. The agreement was modified to provide that some of these receipts would not be paid directly to the doctor but would be used to purchase annuity contracts for him. The court held, in effect, that Dr. Llewellyn had made anticipatory assignments of part of his income to the insurance company.

Under the sales theory, if the taxpayer *cancels* an old agreement and enters into a new one whereby he receives payments for life, the IRS may assert that there has been a *sale or exchange* of the old rights in consideration for an annuity policy. See *Olmsted Inc. Life Agency*, 35 T.C. 428 (1960), *nonacquiesced in*, 1961-2 CUM. BULL. 6, *aff'd*, 304 F.2d 16 (8th Cir. 1962). However, unless the taxpayer actually receives a commercial annuity policy, this theory will probably not cause taxpayers much trouble.

³⁷ This should be contrasted with the economic benefit doctrine which is applicable to determine what is income and the assignment of income doctrine which is applicable to determine who receives income. As with many closely related doctrines, the courts, the IRS, and the commentators have not always observed the proper technical distinctions, and there is some disagreement as to which concept is most applicable to a given factual situation. For some examples of disagreements, see Schlossberg, "Cash Equivalent" and "Constructive Receipt" — How These Doctrines Bring Immediate Taxation, 22 J. TAXATION 18 (1965).

For an interesting discussion of the differences between the constructive receipt doctrine and the economic benefit doctrine, see the opinion in *E.T. Sproull*, 16 T.C. 244, 246-47 (1951).

³⁸ Treas. Reg. § 1.451-1(a) (1957).

³⁹ *Id.* § 1.451-2(a) (1957), T.D. 6723, 1964-1 CUM. BULL. 73.

⁴⁰ *Id.* § 1.446-1(c) (1) (i) (1957), T.D. 6584, 1962-1 CUM. BULL. 67.

ingly used; that amounts due from a corporation but unpaid, are not to be included in the income of an individual reporting his income on a cash receipts basis unless it appears that the money was available to him, that the corporation was able and ready to pay him, that his right to receive was not restricted, and that his failure to receive resulted from exercise of his own choice.⁴¹

In 1960, the Internal Revenue Service issued Revenue Ruling 60-31,⁴² which is still the most authoritative guide on the application of the doctrine of constructive receipt to deferred compensation arrangements. The Ruling sets forth a series of five examples and then proceeds to discuss each of them and to indicate the Service's position on whether the deferral of the income would be given effect for tax purposes.⁴³ In addition, Revenue Ruling 67-449 suggests another planning opportunity.⁴⁴

In considering the concept of constructive receipt, a distinction must again be drawn between funded and nonfunded plans,⁴⁵ and plans in which the employee's rights are forfeitable and those in which his rights are vested. In one particular combination of a funded plan where the employee's rights are vested, constructive receipt is not important because the *Code* itself provides, in section 402(b), for a tax to the employee when the employer deposits in a nonqualified trust, an amount to which the employee has a non-forfeitable right even though actual distribution is delayed.⁴⁶

⁴¹ C.E. Gullett, 31 B.T.A. 1067, 1069 (1935). In the *Gullett* case, the taxpayer was an officer and director of a corporation which was having financial difficulty. In fact, at the time of the case the corporation was in the hands of receivers. The directors had passed a resolution restricting the corporation from paying directors' salaries in full until the financial conditions of the company improved. The company paid only \$6,000 to each director and accrued the remainder on its books. Each director reported the \$6,000 but the Commissioner attempted to have each director's income increased by the difference between the amount drawn and reported by him and the amount accrued and reported by the company, on the theory that those amounts were constructively received by the director-taxpayer. The court held that the doctrine of constructive receipt was not applicable.

⁴² 1960-1 CUM. BULL. 174. This important ruling brought forth a host of articles. E.g., Axelrad, *Deferred Compensation Arrangements and Constructive Receipt of Income: Revenue Ruling, 60-31*, 35 LOS ANGELES B. BULL. 149 (1959); Gordon, *The New Look of Deferred Compensation Contracts*, 10 TUL. TAX INST. 593 (1961); Neal, *Deferred Compensation Plans: Qualifying for Non-Qualified Treatment*, 13 VAND. L. REV. 461 (1960); Rice, *The New Tax Policy on Deferred Compensation*, 59 MICH. L. REV. 381 (1961); *Constructive Receipt on Deferred Compensation Eased by New Ruling*, 12 J. TAXATION 180 (1960).

⁴³ See text accompanying notes 50-53 *infra*.

⁴⁴ 1967 INT. REV. BULL. NO. 51, at 16.

⁴⁵ See text accompanying note 16 *supra*.

⁴⁶ While the rule set forth in CODE § 402(b) is clear, its application, especially in the Sixth Circuit is not clear because of two recent cases involving funded plans. In *George W. Drysdale*, 32 T.C. 378 (1959), *rev'd & remanded*, 277 F.2d 413 (6th Cir.

The concept of constructive receipt is important in the other combinations as illustrated by the following examples. The first examples are those in which the constructive receipt theory will not be applied. Subsequent examples illustrate some "red flag" situations, which should be analyzed carefully before assurances are made to the employee, and some situations which will almost certainly cause the application of the constructive receipt doctrine and premature taxation of the employee's benefits.

(1) *Situations Which Should Cause No Constructive Receipt Problems.* —Revenue Ruling 60-31 provides that "the statute [Code section 451] cannot be administered by speculating whether the payor would have been willing to agree to an earlier payment."⁴⁷ The Ruling cites the *C.E. Gullett* case⁴⁸ and the *J.D. Amend* case⁴⁹ and apparently indicates approval of them. The Ruling also sets forth three examples of commonly used deferred compensation arrangements in which no constructive receipt problem is involved.

In the first example, the taxpayer was to be employed by a corporation for 5 years at a stated annual salary, plus additional compensation, of \$10,000 per year. The additional compensation was to be credited to a bookkeeping reserve account and deferred, accumulated, and paid in five installments upon termination of the taxpayer's full-time employment with the corporation. No trust was created by the bookkeeping reserve — the corporation being merely under a contractual obligation to make the payments.⁵⁰

In the second example, the taxpayer was an officer and director of the corporation which adopted a plan whereby a percentage of

1960), the Government did not urge the application of section 402(b) and the case was decided for the taxpayer based on the lack of any constructive receipt or economic benefit. In *Doty v. United States*, 207 F. Supp. 227 (E.D. Mich. 1962), *rev'd*, 323 F.2d 649 (6th Cir. 1963), which was stipulated to be factually identical to the *Drysdale* case, the Government advanced the application of section 402(b) because the employer contributed to a trust in which the employee's interest was nonforfeitable. The district court agreed with the Government and decided against the taxpayer. However, the case was reversed on appeal for two reasons. First, the appellate court thought that the employee's interests were forfeitable, 323 F.2d at 650, which is not too disturbing because the facts are somewhat complicated and the point is disputable. However, the appellate court also indicated that it felt compelled to follow the *Drysdale* case because of stare decisis. *Id.* This causes some doubt as to the future application of section 402(b) in the Sixth Circuit. In *Doty* the dispute was placed on the suspended docket while *Drysdale* was being appealed, and this may have something to do with the Sixth Circuit's refusal to give the Government another "bite at the apple."

⁴⁷ 1960-1 CUM. BULL. 174, 178.

⁴⁸ 31 B.T.A. 1067 (1935); see note 41 *supra*.

⁴⁹ 13 T.C. 178 (1949), *acquiesced in*, 1950-1 CUM. BULL. 1.

⁵⁰ Rev. Rul. 60-31 (example 1), 1960-1 CUM. BULL. 174, 175.

the annual net earnings in excess of a certain figure was designated for division among the participants in proportion to their respective salaries. The amount was not currently paid to the participants, but the corporation each year credited the amount of the participant's share for that year on its books in each participant's separate account. The participants were paid from the account annually beginning when the employee either reached age 60, was no longer employed by the company, or became totally disabled. The corporation's liability to make the payments was contingent upon the employee refraining from engaging in any business competitive to that of the corporation, making himself available to the corporation for consultation and advice after retirement or termination of services, and retaining unencumbered any interest in the plan. If the employee died either before or after the beginning of payments, amounts in the employee's account were distributable in installments to his beneficiaries. Again, no trust was created for the benefit of the employees, and the corporation was merely under a contractual obligation to make the payments.⁵¹

In the third example, the taxpayer, an author, and the corporation, a publisher, executed an agreement under which the taxpayer granted to the publisher the exclusive right to sell a book he had written. This agreement provided that the publisher would pay the author specified royalties based on the money received from the sale. On the same day another agreement was signed in which the parties mutually agreed that the publisher would not pay the taxpayer more than \$100,000 in any calendar year notwithstanding any contrary provisions contained in the first contract. Under the second contract, sums in excess of \$100,000 accruing in any one year were to be carried over by the publisher into future accounting periods and the publisher was not required either to pay interest to the taxpayer on any such excess sums or to segregate any such sums in any manner.⁵²

Another specific plan has been approved by the IRS as set forth in a recent revenue ruling, the facts of which are as follows:

Under the deferred compensation plan, awards of supplemental compensation are generally payable to key employees in equal cash installments in each of 4 years beginning with the year in which the award is made. The first installment is payable on or before April 15 of the year the award is made. An additional installment

⁵¹ *Id.* (example 2), at 175-76.

⁵² *Id.* (example 3), at 176.

becomes payable on January 10 of each of the three succeeding years.

The right of an employee to receive payment of any installment of an award subsequent to the first installment will accrue only if, during the entire period from the making of the award until December 31 of the year preceding that in which the installment is payable, he has *earned out* such installment. An award installment is earned out by continuing in the employ of the employer or, if employment is terminated for a reason other than death, by (1) refraining from (A) engaging . . . in competition with the employer, or (B) entering the service of any organization engaged in competition with the employer; and (2) making himself available . . . [for consultative services] while . . . in the employ of the employer.

Each installment of an award may, at the employee's election, be deferred until after the termination of employment, at which time it may be paid in one or more installments of cash or the employer's common stock. The right to receive any such deferred payment shall accrue only if, during the entire period from the termination of any employee's employment until December 31 of the year preceding that in which such payment is to be made, the above conditions have been satisfied.

In addition to the election to defer an installment of a supplemental compensation award, the plan provides employees with an election as to the manner (year and amount) in which any such installment which he elects to defer is to be paid following the termination of employment.

The initial election is required to be made not later than December 15 of the year preceding the year in which the installment would otherwise become payable. The subsequent election is required to be made prior to the termination of employment.⁵³

These four examples may be taken as absolutely free from any constructive receipt problem.

In addition, the following three cases illustrate specific situations in which no constructive receipt problem should exist at the present time.

In the *James F. Oates* case,⁵⁴ the taxpayer was an insurance agent about to retire. He and other agents entered into negotiations with their employer-insurance company to modify their commission payment arrangement. Under the previously existing arrangements, the agents received a relatively large commission on the first premium and successively smaller commissions on the next nine renewal premiums, which resulted in the income of a retired agent constantly decreasing after retirement. Dissatisfied with this

⁵³ *Id.* 67-449, 1967 INT. REV. BULL. NO. 51, at 16.

⁵⁴ 18 T.C. 570 (1952), *aff'd*, 207 F.2d 711 (7th Cir. 1953), *acquiesced in*, Rev. Rul. 60-31, 1960-1 CUM. BULL. 174, *withdrawing prior nonacquiescence in*, 1952-2 CUM. BULL. 5.

result, the agents negotiated a new contract with the company which provided in substance that the commissions which would accrue after the retirement of the agent would be paid in fixed monthly installments irrespective of the time when the company collected them. The Commissioner attempted to assess a tax deficiency against Mr. Oates based on the difference between the monthly payments which he actually received and the renewal commissions which he would have been entitled to receive had he not entered into the modified contract a few days before his retirement, on the theory that he had constructively received that income. Both the Tax Court and the federal circuit court held for the taxpayer saying, in effect, that there had been a novation.⁵⁵ The Tax Court reasoned that because the parties had a right to negotiate the old contract, they also had a right to negotiate the new one. The most important factors in the case⁵⁶ were that the new contract was entered into before the due date for the first payments covered by the old contract, there was a valid business purpose⁵⁷ for the new

⁵⁵ A novation is a contract that: "(a) discharges immediately a previous contractual duty . . . , and (b) creates a new contractual duty, and (c) includes as a party one who neither owed the previous duty nor was entitled to its performance." RESTATEMENT OF CONTRACTS § 424 (1932).

Since the first contract was between Mr. Oates and the insurance company, and the second contract was between Mr. Oates and the insurance company, this reasoning could be challenged.

⁵⁶ The factors are indicated in the often quoted last paragraph of the federal court's opinion:

This case is far removed from such decisions. [Helvering v. Eubank, 311 U.S. 122 (1940); Helvering v. Horst, 311 U.S. 112 (1940); Lucas v. Earl, 281 U.S. 111 (1930)]. Here the parties were confronted by a situation where inconvenience and resulting dissatisfaction came to the retired agents by reason of the constantly decreasing payments made by the company under the original contract. To relieve the situation, the company and the taxpayer, after full and complete negotiations, before retirement of the agent, agreed to abrogate and annul the old contract, to substitute a new one and thus to improve the unsatisfactory posture of affairs. The taxpayer did not reduce to his immediate possession or to his present enjoyment anything that might thereafter accrue to him. He made no assignment; he took no dominion over the accrued commissions other than to agree to receive them in cash installments as they matured under the contract. He did nothing to charge himself with the economic benefit to be derived from the accruing commissions but, on the contrary, let them accumulate under the agreement whereby the company was to pay the same amount every month rather than constantly decreasing amounts. 207 F.2d at 713-14.

⁵⁷ While federal courts in subsequent cases have criticized the "business purpose" gloss on the literal meaning of tax laws, it still seems to be important in the Tax Court. See, e.g., George W. Drysdale, 32 T.C. 378 (1959), *rev'd*, 277 F.2d 413 (6th Cir. 1960); James F. Oates, 18 T.C. 570 (1952), *aff'd*, 207 F.2d 711 (7th Cir. 1953), *acquiesced in*, Rev. Rul. 60-31, 1960-1 CUM. BULL. 174; Howard Veit, 8 T.C. 809 (1947), *acquiesced in*, 1947-2 CUM. BULL. 4. See also Gemmill, *The "Economic Benefit" Attack on Non-qualified Plans; Cautions for Draftsmen*, 22 J. TAXATION 79 (1965).

contract in that many agents were not satisfied with the old one for good reasons, and the taxpayer received nothing tangible which might be termed an economic benefit.

In the *Howard Veit*⁵⁸ case, the taxpayer was a participant in a profit sharing plan. The plan called for a certain part of the company's profits to be paid to the taxpayer at a certain time.⁵⁹ Before the payments were actually due, the taxpayer and the corporation entered into another agreement providing for a slight deferral of the payments. The Government attempted to assess a deficiency based on the difference between the amounts actually received and reported by the taxpayer and the amounts he would have received had he not entered into the subsequent contract. In refuting the Government's argument, the Tax Court stated:

The only way we should be justified in holding that the petitioner constructively received [the amount in question] in 1941 would be to hold that the agreement to defer the payment . . . was a mere subterfuge, and sham for the purpose of enabling petitioner to postpone his income tax on the amount to another year.⁶⁰

Later, the same taxpayer executed another agreement with his employer whereby the amounts due under the first modification of the agreement were to be deferred again for a period totaling 4 years.⁶¹ In again holding for the taxpayer, the Tax Court cited its prior decision involving Mr. Veit and said, "[t]here was never a time when [the amount due] was unqualifiedly subject to petitioner's demand or withdrawal. He did not voluntarily refrain from collecting money available for him, nor did he agree to the debtor's deferred payment of money available when the agreements were made."⁶²

In the *Olmsted Inc. Life Agency* case,⁶³ the taxpayer was a corporation doing business as an insurance agency, which had a contract with an insurance company to act as an exclusive territorial

⁵⁸ 8 T.C. 809 (1947), *acquiesced in*, 1947-2 CUM. BULL. 4 (sometimes called the first *Veit* case).

⁵⁹ An interesting feature of the plan in this case was that it not only called for payments to Mr. Veit if there were profits, but also called for payments by Mr. Veit to the corporation if there were losses.

⁶⁰ 8 T.C. at 816.

⁶¹ This is often called the second *Veit* case; *Howard Veit*, 49 P-H Tax Ct. Mem. 811 (1949).

⁶² *Id.* at 814. The court dismissed the fact that the corporation had taken a deduction for the full amount of the payments in 1 year because the corporation was an accrual taxpayer and the executive was a cash basis taxpayer.

⁶³ 35 T.C. 429 (1960), *nonacquiesced in*, 1961-2 CUM. BULL. 4, *aff'd*, 304 F.2d 16 (8th Cir. 1962).

agency. As of midnight, December 31, 1955, the parties entered into an agreement whereby the old contract was cancelled and the taxpayer assigned to the insurance company all of its rights in renewal commissions earned previously and payable after January 1, 1956. The taxpayer agreed also to turn over to the insurance company all of its records and, in return, the insurance company agreed to pay the taxpayer \$500 per month for the next 15 years, which sum was based on the present value of all the renewal commissions already earned. There was evidence that the transaction was entered into at least in part because of the failing health of Mr. Olmsted, the major shareholder of the taxpayer corporation. The Government attempted to increase the taxpayer's income by the difference between the payments actually received and the present value of the renewal commissions on the theory that there had been a "sale" of the right to those commissions and that the consideration therefor was an annuity contract, the present value of which was the value of the renewal commissions. Both the Tax Court and the federal court relied on the *Oates* case and held that there was no sale and that the payments to the taxpayer were taxable only when actually received.⁶⁴

(2) *Illustrations of Potential Applications of Constructive Receipts.*—Plans substantially similar to the above arrangements should have no constructive receipt problems. On the other hand, the examples which follow illustrate situations in which great care should be exercised. The *George W. Drysdale* case⁶⁵ is set forth in detail because of its general importance in the field and because it illustrates the Tax Court's continued reliance on the business purpose doctrine. For planning purposes, the *Drysdale* case can be cited for the proposition that in any arrangement in which it can be established that the employer was willing to pay the compensation directly to the employee currently, and in which the deferral or establishment of a trust serves no readily ascertainable business purpose, problems which cannot be resolved at the admin-

⁶⁴ In Stuetzer, *Deferred Compensation Contracts: Individual Contracts: Non-qualified General Plans*, N.Y.U. 21ST INST. ON FED. TAX. 479 (1963), the author sums up the effect of these cases as follows:

The courts seem to be expressing reluctance to tax executives who are parties to contracts or plans which confer nothing of possible present value. Similarly they seem to be permitting deferral of income that might be considered earned if such deferral precedes the original due date of payment and is accompanied by some valid business purpose that indicates that the contractual relationship is not a sham.

⁶⁵ 32 T.C. 378 (1959), *rev'd & remanded*, 277 F.2d 413 (6th Cir. 1960).

istrative level should not be taken to the Tax Court, but rather should be taken to the federal courts in a refund suit.

The situations set forth after the *Drysdale* case are examples of situations which do not necessarily have constructive receipt problems, but which should be approached with caution and should not necessarily be considered as sanctioned by Revenue Ruling 60-31 or Revenue Ruling 67-449.

In the *Drysdale* case,⁶⁶ the taxpayer worked for the Briggs corporation under an employment contract which called for a salary of about \$72,000 per year and contained the following provision:

In the event such full time employment of [Drysdale] should terminate prior to his attaining the age of sixty-five years for any reason other than the death of [Drysdale], then [Drysdale] shall while living . . . be paid monthly an amount not less than \$1500 . . . such payments to start thirty days after termination of such full time employment and to continue for ten years thereafter.⁶⁷

Subsequently, Briggs sold most of its operation to Chrysler, and Chrysler then employed Drysdale on a full-time basis. However, Briggs desired to continue to employ Drysdale on an advisory basis and entered into an agreement calling for payments of \$1,500 per month to a trust for Drysdale's benefit, the corpus of the trust to be distributed to Drysdale after he retired. There was evidence that Briggs was willing to pay the money directly to Drysdale. The Tax Court held that the entire payments to the trust were income to the taxpayer in the years they were paid into the trust, on the basis of constructive receipt. The court distinguished the *Oates* case on the basis that a business purpose motivated the agreement in *Oates* while no such purpose was present in the *Drysdale* situation. In discussing the distinction, the court stated:

In the instant case, however, the only apparent purpose of Briggs' making the payments to a trustee instead of to petitioner directly was to reduce petitioner's tax burden. . . . The facts and circumstances surrounding the execution of the amended employment contract compel the conclusion that the payments to the trustee pursuant to the contract were compensation for the advisory services rendered by petitioner during the years in issue, and petitioner, apparently of his own volition and for no purpose other than to defer the reporting of income effected a self imposed limitation on his right to receive the payments direct. For this reason the instant case is distinguishable from *Oates* . . . and fall[s] squarely within the scope of *Williams v. United States*.⁶⁸

⁶⁶ *Id.* noted in 43 MARQ. L. REV. 389 (1960).

⁶⁷ 32 T.C. at 379.

⁶⁸ *Id.* at 384, citing *Williams v. United States*, 219 F.2d 523 (5th Cir. 1955).

The Sixth Circuit in reversing and remanding the decision of the Tax Court held that there was no constructive receipt of the money deposited in the trust because "at no time did the petitioner have any right to the immediate possession or enjoyment of anything."⁶⁹ The court also held that the economic benefit doctrine was inapplicable.⁷⁰

In addition to the general warning expressed in the *Drysdale* case, the following particular situations should not be considered squarely under the protection of Revenue Ruling 60-31 or Revenue Ruling 67-449: (1) the deferral of income which is fully earned but not yet payable without forfeiture conditions; (2) any deferral arrangement which contemplates a *reduction* of current compensation without forfeiture conditions; (3) the deferral of customary bonuses or regular annual salary increases without forfeiture conditions; and (4) any arrangement which permits an *election* to receive the deferred amounts currently⁷¹ or to defer amounts otherwise currently receivable without forfeiture conditions.⁷²

(3) *Situations Which Will Definitely Cause the Application of the Doctrine of Constructive Receipt.* —Revenue Ruling 60-31 cautions that "under the doctrine of constructive receipt, a taxpayer may not deliberately turn his back upon income and thereby select the year for which he will report it. Nor may a taxpayer, by a private agreement, postpone receipt of income from one taxable year to another."⁷³ A classic case involving this so-called "turning of the back on income" theory is *Williams v. United States*.⁷⁴

In *Williams* the taxpayer sold timber to a purchaser who was willing and able to pay the full purchase price immediately. The taxpayer, however, insisted on an irrevocable escrow agreement

⁶⁹ *Drysdale v. Commissioner*, 277 F.2d 413, 417 (6th Cir. 1960).

⁷⁰ *Id.* at 218. The economic benefit doctrine was referred to in the Tax Court's opinion, but since it decided that the payments were taxable on the constructive receipt theory, it was not discussed. The Tax Court's opinion also referred to CODE § 402(b), on which the Sixth Circuit did not comment. This set the stage for the *Doty* problem which came before the Sixth Circuit in 1963. See discussion note 46 *supra*.

⁷¹ Rev. Rul. 60-31 did a service to tax planners in the deferred compensation field but it did not answer all questions. The Ruling expressly cautioned that except in factual situations substantially similar to those set forth in the examples, each case was to be determined on its own merits. The following statement which appeared twice in Revenue Ruling 60-31 should be kept in mind: "it seems clear that in each case involving a deferral of compensation a determination of whether the doctrine of constructive receipt is applicable must be made upon the basis of the special factual situation."

⁷² See text accompanying note 52 *supra*.

⁷³ 1960-1 CUM. BULL. 174, 178; see, e.g., *James E. Lewis*, 30 B.T.A. 318 (1934); *Hamilton Nat'l Bank*, 29 B.T.A. 63 (1933).

⁷⁴ 219 F.2d 523 (5th Cir. 1955).

whereby he would receive the purchase price over a period of 5 years. The sole purpose for the escrow agreement was to save taxes by spreading the receipt of the money and the reporting of income over a 5-year period. Holding the entire purchase price to be income to the taxpayer in the year of sale, the Fifth Circuit reasoned that when the prospective purchaser desired and offered to pay the full purchase price, the taxpayer was in constructive receipt of the money and the self-imposed limitation of the escrow agreement had no substantive effect upon the transaction.⁷⁵

Another clear case for the application of the doctrine of constructive receipt is the *Joseph Frank* case.⁷⁶ The taxpayer and his employer-corporation reached an agreement in December 1946 whereby the corporation would pay the taxpayer a specified amount of cash. Funds sufficient to pay the amount were on deposit in a special bank account and testimony at the trial showed that the corporation was ready and willing to pay immediately. Yet, at the request of the taxpayer's counsel, the payment was deferred to January 1947. (The corporation was on a fiscal year ending July 31, so it had no preference as to when the payment was to be made.) The Tax Court, however, refused to allow the deferral and held that the taxpayer constructively received the amounts in 1946.⁷⁷

In summary, the constructive receipt theory should not trouble the executive who is still a few years from retirement and enters into a contract whereby his original salary is increased by a certain amount which is deferred until after retirement. The employee who is taking a new position and negotiates a deferred compensation contract should have no constructive receipt problems if reasonable discretion is used in the ratio of current compensation to deferred compensation. Caution should be observed in materially reducing the present salary and paying a part currently (while the

⁷⁵ For a situation in which an escrow arrangement was used and the economic benefit doctrine was applied, see *E.T. Sproull*, 16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952); see Rev. Rul. 60-31 (example 4), 1960-1 CUM. BULL. 174, 178.

⁷⁶ 22 T.C. 945 (1954), *aff'd per curiam*, 226 F.2d 600 (6th Cir. 1955).

⁷⁷ The *Frank* case is somewhat complicated by the taxpayer's original assertion, which was later abandoned, that a certain part of the settlement was payment for an alleged assault and therefore not taxable. The taxpayer's later admission that there was no assault must have put him in a rather bad light before the court. 22 T.C. at 952. In addition, the language of the Tax Court seems to indicate that it relied to some extent on the so-called business purpose doctrine, which has since been repudiated at least in the Sixth Circuit. See, e.g., *Drysdale v. Commissioner*, 277 F.2d 413 (6th Cir. 1960). For other cases applying the constructive receipt theory, see *Hineman v. Brodrick*, 99 F. Supp. 582 (D. Kan. 1951); *Frank W. Kunze*, 19 T.C. 29 (1952), *aff'd per curiam*, 203 F.2d 957 (2d Cir. 1953).

employee is still performing the same services) and the remainder after retirement, with no conditions.⁷⁸

The second major weapon of the IRS in its attempt to assert immediate taxation of deferred compensation arrangements is the economic benefit theory. The basis of the theory lies in the following language of the regulations:

If services are paid for other than in money the fair market value of the property or services taken in payment must be included in income.⁷⁹

Notes or other evidences of indebtedness received in payment for services constitute income in the amount of their fair market value at the time of the transfer.⁸⁰

Items of gross income . . . in the computation of taxable income need not be in the form of cash. It is sufficient that such items can be valued in terms of money.⁸¹

In the field of deferred compensation, the economic benefit doctrine is used to impose an immediate tax on the employee where the employer actually gives property to the employee, gives property to a third party to hold for the employee, or itself holds or sets property aside for the employee. The theory will not generally be applied unless the employee has a *nonforfeitable* interest in the property and his rights are *assignable*.

Generally, there must be something besides the deferred compensation contract itself in order for the theory to be applied.⁸² Of course, negotiable instruments would be sufficient, and, indeed, evidences of indebtedness not negotiable in the ordinary sense, but which in fact can be sold, have caused application of the theory.⁸³

⁷⁸ For an interesting application of the constructive receipt theory to insurance policies, see Theodore H. Cohen, 39 T.C. 1055 (1963). This case held that the periodic increases in the cash value of insurance contracts do not constitute constructively received income to the owner of the policy because the realization of this amount is subject to substantial restrictions — the policy has to be cashed in to get it, *id.* at 1063, and that the interest, (or dividends left on deposit) does constitute income constructively received by the owner of the policy because such amounts are subject to the owner's unfettered right to withdraw it. *Id.* at 1064. See also Finnegan, *Constructive Receipt of Income*, N.Y.U. 22D INST. ON FED. TAX. 367, 379 (1964).

⁷⁹ Treas. Reg. § 1.61-2(d)(1) (1957).

⁸⁰ *Id.* § 1.61-2(d)(4) (1957).

⁸¹ *Id.* § 1.446-1(a)(3) (1957), T.D. 6584, 1962-1 CUM. BULL. 67, T.D. 6834, 1965-2 CUM. BULL. 958.

⁸² To invoke application of the economic benefit doctrine the "extra ingredient" besides the deferred compensation contract can be *stock*, see *Commissioner v. LoBue*, 351 U.S. 243 (1956), *insurance policies*, see N. Loring Danforth, 18 B.T.A. 1221 (1930), or an *annuity contract*, see *William E. Freeman*, 4 T.C. 582 (1954).

⁸³ See, e.g., *Frank Cowden, Sr.*, 32 T.C. 853 (1959), *rev'd & remanded*, 289 F.2d 20 (5th Cir. 1961), *opinion on remand*, 30 P-H Tax Ct. Mem. 1239 (1961).

Perhaps the classic economic benefit case is the *E.T. Sproull* case.⁸⁴ Mr. Sproull was an employee of a corporation under a contract which called for a salary of \$12,000 per year. Beginning in 1929, the corporation was unable to pay the salary because of the depression, so Mr. Sproull voluntarily agreed to take a smaller salary. By 1945, the company was financially stronger and agreed with Mr. Sproull that in consideration for past services rendered the corporation would pay over to a trustee the sum of \$10,000 in that year. The trustee was directed to hold, to invest, and to pay over this sum to Mr. Sproull or to his estate in two installments, one in 1946, and the other in 1947. Mr. Sproull's rights in the trust were vested and presumably assignable. Both the Tax Court and the Sixth Circuit held that the entire trust fund was income to Mr. Sproull in 1945, the year in which he had received an economic benefit.⁸⁵

Revenue Ruling 60-31⁸⁶ provides an example of a situation in which the economic benefit doctrine is applied in the context of an escrow arrangement. In the example, a football player, upon execution of a contract to play professional football, was awarded a bonus which was paid to a designated escrow agent for later payment to the football player. The Ruling stated that the creation of this escrow fund in which the football player had nonforfeitable rights was a sufficient economic benefit to justify its immediate taxation to him in the year in which the contract was executed. Although no explicit discussion concerned the assignability of the football player's rights under the escrow agreement, the example did state that the agreement would be binding on the party's successors and *assigns*, thus implying that a case in which the employee's rights were expressly unassignable could be distinguished.

Perhaps the most important case involving economic benefit is the *Frank Cowden, Sr.* case.⁸⁷ The facts concerned taxpayers who granted a mineral lease for certain oil properties. The lessee was willing and able to pay the entire purchase price in the year in which the contract was executed, but the taxpayers requested that

⁸⁴ 16 T.C. 244 (1951), *aff'd*, 194 F.2d 541 (6th Cir. 1952).

⁸⁵ The court relied principally on the cases of *Renton K. Brodie*, 1 T.C. 275 (1942), and *J.H. McEwen*, 6 T.C. 1018 (1946), which involved annuity contracts. 16 T.C. at 247. It is interesting to note that in the *Brodie* case, one of the arguments of the taxpayer was that the annuity had no cash value and could not be *assigned*.

⁸⁶ Rev. Rul. 60-31 (example 4), 1960-1 CUM. BULL. 174, 176-77.

⁸⁷ 32 T.C. 853 (1959), *rev'd & remanded*, 289 F.2d 20 (5th Cir. 1961), *opinion on remand*, 30 P-H Tax Ct. Mem. 1239 (1961), *noted in* 59 COLUM. L. REV. 1237 (1959).

the payments be deferred, some to be paid on execution and additional amounts to be paid each year for the next 2 years. *The lessee's obligation to make the additional payments in the subsequent years was evidenced by separate instruments signed by the lessee.* The taxpayers received the payments called for at execution and reported only those payments in their income for that year. The Commissioner attempted to assess a deficiency based on the difference between the amounts actually received and reported and the entire amount called for by the contract and evidenced by the separate certificates. The Tax Court held for the Commissioner on the economic benefit theory. The court thought that the taxpayers received an economic benefit when they received the contract and the separate instruments evidencing the lessee's liability to pay. The court emphasized the following facts:

payors were perfectly willing and able at the time of execution of the leases . . . to pay . . . in an immediate lump-sum payment; . . . [one of the taxpayers] believed the bonus agreements had a market value at the time of their execution; that a bank in which he was an officer and depositor was willing to and in fact did purchase such rights at a nominal discount; that the bank considered such rights to be bankable and to represent direct obligations of the payor; that the bank generally dealt in such contracts where it was satisfied with the financial responsibility of the payor and looked solely to it for payment without recourse to the lessor and, in short, that the sole reason why bonuses were not immediately paid in cash upon execution of the leases involved was the refusal of the lessor to receive such payments. We are convinced from the particular facts of this case that . . . the bonus payments were not only readily but immediately convertible to and were the equivalent of cash and for that reason had a fair market value in their face amounts.⁸⁸

The Court of Appeals for the Fifth Circuit reversed and remanded the Tax Court's decision.⁸⁹ The court of appeals said, in effect, that (1) the Tax Court should have disregarded the willingness of the lessor to pay immediately; (2) the Tax Court's dissenting opinion stating, in effect, that whether an instrument had fair market value depended upon negotiability was not valid, it being "as unrealistic as it is formalistic";⁹⁰ and (3) as a general proposition, an

⁸⁸ 32 T.C. at 858. There was an interesting dissenting opinion by two Tax Court judges, which spoke of "constructive receipt" but apparently meant economic benefit in the context in which it was used. *Id.* at 860. Also, the dissent apparently thought that the line between instruments having fair market value and those having merely intrinsic value should be drawn at the line of negotiability. *Id.* at 858.

⁸⁹ *Cowden v. Commissioner*, 289 F.2d 20 (5th Cir. 1961).

⁹⁰ *Id.* at 24.

executory contract to make future payments in money does not have a fair market value, *but* the other *separate* instrument may have a fair market value.

The court of appeals remanded the case to the Tax Court to determine, without considering the willingness of the lessor to pay or the lessee to receive the full amounts on execution of the leases, whether the bonus obligations evidenced by the separate writing were taxable in the year of the agreement as the equivalent of cash.

On remand, the Tax Court determined that the obligations of the company were the equivalent of cash.⁹¹ In view of the particular facts of the *Cowden* case, there can be little argument with the final result. Yet, the case is significant in that it illustrates the dangers of allowing an assignment of the employee's rights and incorporating the obligation to pay in a separate instrument, which is in addition to the basic contract.

The *Harold G. Perkins* case⁹² is an example of a situation in which a trust was created for the benefit of some key employees and the economic benefit theory was not applied. According to the terms of the trust agreement involved in the case, the employ-

⁹¹ Frank Cowden, Sr., 30 P-H Tax Ct. Mem. 1239 (1961). The *Cowden* case was distinguished in Leonard Hyatt, 30 P-H Tax Ct. Mem. 1789 (1961), *aff'd per curiam*, 325 F.2d 715 (5th Cir. 1963). The *Hyatt* case seemed to restrictively interpret the *Cowden* case and limit it to its particular facts. The Tax Court stated:

The facts in the case before us [*Hyatt*] are distinguishable from those involved in [*Cowden*] in which the taxpayers acquired an advance royalty or bonus contract as part consideration for the execution of a mineral lease to an oil company. There the obligor was clearly able to fulfill its contractual obligation. The taxpayers believed that the bonus agreement had an ascertainable fair market value at the time of its execution. They intended to sell the bonus agreement prior to maturity and in fact did sell it to a bank at a nominal discount shortly after the time of acquisition. The bank which purchased the bonus contract previously had dealt in such agreements and considered them to be "bankable." We there found [on remand] that the bonus contract in question was readily convertible and was converted to cash and therefore was the equivalent thereof.

In the instant case Hyatt did not sell the assignment agreement he acquired from United Security The record does not indicate that he had any intention of selling it prior to maturity or that he had any knowledge of a prospective purchaser. Further, it does not appear that Hyatt believed or that in these circumstances he reasonably could have believed that the assignment contract had an ascertainable fair market value at the time of execution. *Id.* at 1805.

⁹² 8 T.C. 1051 (1947). See also Clifton B. Russell, 5 T.C. 974 (1945), *acquiesced in*, 1946-1 CUM. BULL. 4, where the employer agreed to pay a bonus to Russell in 1941 on such terms as the treasurer elected during the current fiscal year of the corporation, which ended on March 31. The corporation decided in 1941 to pay Russell half his bonus in cash immediately and to establish a trust for him with the other half. Half was paid in 1941, and reported as income, and the other half was put into the trust, which was not established until 1942. Under these facts, the court held that neither the economic benefit doctrine nor the constructive receipt doctrine was applicable.

ees had to remain with the employer for 5 years in order to receive the benefits. If they left before then, one-half of their benefits would be forfeited and allocated to the other participants. The Tax Court held that, as to the one-half which was *forfeitable*, the economic benefit doctrine did not apply.⁹³

In summary, the problem of economic benefit will be avoided if the employee is (1) given nothing tangible besides the contract which spells out the agreement; (2) the contract contains a provision against assignment; and (3) no fund (escrow, trust, or insurance) is established for the employee in which he obtains *nonforfeitable* rights, and which purports to be insulated from the claims of general creditors of the employer.

*D. Assuring Both the Employer and the Executive that There Will Be No Other Disadvantages Created by the Plan or Distributions from the Plan*⁹⁴

Unless proper care is taken, a deferred compensation agreement can cause unexpected problems in other unrelated areas. Generally, an awareness of these potential trouble spots will be sufficient to avoid them. The major points of possible detrimental interaction are outlined below.

(1) *Income Tax — Withholding Requirements.* —As a general proposition, if the employee will be taxed on the employer's payments to him, the employer will be required to withhold income taxes. If the employee realizes no immediate taxable income, however, then a withholding will not be required merely because amounts are set aside in a funded arrangement for the employee.⁹⁵ Specific treasury regulations⁹⁶ provide for exemption from the income tax withholding provisions for subsequent distributions from the fund to the employee.

(2) *Income Tax — Payments to Beneficiary.* —If an employee designates a beneficiary to receive payments due him under a plan

⁹³ The employer's deduction was not at issue in this case. Presumably, the employer was not entitled to the deduction for the forfeitable contributions to the trust. See discussion in text accompanying note 17 *supra*.

⁹⁴ A more descriptive name for this section would be "Miscellaneous Ways To Get in Trouble."

⁹⁵ 20-2d T.M. PORTFOLIO, *supra* note 1, at A25-26.

⁹⁶ Treas. Reg. § 1.402(b)-1(b) (1956), T.D. 6783, 1965-1 CUM. BULL. 180, T.D. 6885, 1966-2 CUM. BULL. 307; *id.* § 1.403(a)-1(b) (1956), T.D. 6676, 1963-2 CUM. BULL. 41, T.D. 6885, 1966-2 CUM. BULL. 307.

during the employee's life, the classic assignment of income cases⁹⁷ would undoubtedly apply and the payments would be income to the employee and not to the recipient-beneficiary.⁹⁸ If the payments are made to the executive's estate or to beneficiaries after his death, these payments are income "in respect of a decedent."⁹⁹

In a nonqualified plan, the \$5,000 death benefit exclusion from taxable income applicable to the employer's contributions relates only to the portion of the benefit which was *forfeitable* immediately before death.¹⁰⁰

(3) *Income Tax — Capital Gains — Qualified Plans.* —If the employee is covered by both a nonqualified deferred compensation agreement which calls for him to render consultative services after retirement and a qualified pension or profit sharing plan in which lump-sum payments are possible, then it is important to determine whether the employee, in performing the services, is doing so as an employee or as an independent contractor. If he is acting as an employee, he has not terminated his employment and any lump-sum payment from a qualified retirement plan will be treated as ordinary income instead of as a long term capital gain.¹⁰¹

(4) *Income Tax Penalties.* —*Internal Revenue Code* section 6601(a) provides that a 6 percent per annum interest penalty may be charged on any deficiency, but the interest itself is deductible. In addition, there are other penalties for negligent or intentional disregard of the income tax laws.¹⁰²

(5) *Social Security Benefits.* —If the employee is under age 72 and receives social security benefits, the deferred compensation plan should not cause the loss or reduction of these benefits by providing, or being open to, the interpretation that some of the deferred compensation is being paid for consultative services.¹⁰³

⁹⁷ See *Helvering v. Eubank*, 311 U.S. 122 (1940); *Helvering v. Horst*, 311 U.S. 112 (1940); *Lucas v. Earl*, 281 U.S. 111 (1930).

⁹⁸ See also *Treas. Reg.* § 1.671-1(c) (1956).

⁹⁹ *Id.* § 1.691(a)-2(b) (1956) (example 4); 1 A. CASNER, *ESTATE PLANNING* 362-73 (3d ed. 1961).

¹⁰⁰ *CODE* § 101(b)(1); *Treas. Reg.* § 1.691(a)-1(d) (1957), T.D. 6808, 1965-1 CUM. BULL. 257. See also Harrison, *Deferred Compensation Plans Have Hidden Estate Planning Problems*, 21 J. TAXATION 16 (1964).

¹⁰¹ For further discussion of this problem, see Harrison, *supra* note 100, at 18. Mr. Harrison suggests that it would be helpful to have specific provisions in the document allowing the executive to arrange his own time to work and permitting him to work where he chooses.

¹⁰² See, e.g., *CODE* § 6653(a).

¹⁰³ *Social Security Act* §§ 203(b), (f), 42 U.S.C. § 301 (1964).

This can occur if the employee is required to render "substantial"¹⁰⁴ consultative services in order to receive the compensation.¹⁰⁵

(6) *Estate Planning — Estate Tax.* —If a deferred compensation arrangement provides for payments to the employee if living and to his estate or to a beneficiary designated by him if not living, the present value of any future payments is includible in his gross estate for federal estate tax purposes. This is usually not deemed to be a significant disadvantage. If the plan provides for lump-sum or commuted payments at the death of the executive, a substantial advantage will be gained in providing additional liquidity in the estate. If no such lump sum or commuted payments are offered, the estate plan should be analyzed to make sure that the estate will be sufficiently liquid to meet the increased estate taxes and expenses of administration caused by the increase in the gross estate because of the inclusion of the present value of the future payments.¹⁰⁶

(7) *Estate Planning — Marital Deduction.* —The basic estate planning problem to be considered in deferred compensation plans is whether to qualify the death benefits for the marital deduction. Assuming that the deferred compensation amounts are not required for payment of taxes and expenses of administration, it would be desirable to have this usually highly liquid asset qualify for the marital deduction trust, since that trust should be consumed first in order to minimize the estate taxes on the death of the surviving spouse. Section 691(a)(1), however, allows an income tax deduction to the beneficiaries for any estate taxes attributable to such a death benefit. If the benefit is used to provide a marital deduction, there are no estate taxes attributable to it and therefore no income tax deduction.¹⁰⁷ It may therefore be advisable to have

¹⁰⁴ "Substantial" is generally considered to be 45 hours per month or more. See 20 C.F.R. § 404.416a(a)(2) (1967).

¹⁰⁵ The employee-independent contractor question is also present here. See 20 C.F.R. §§ 404.1027(b), (c) (1967); Social Security Ruling 61-41, 1960-61 SOC. SEC. CUM. BULL. 57; G.T. WASHINGTON & V. ROTHSCILD, COMPENSATING THE CORPORATE EXECUTIVE 158 (3d ed. 1962); Rivers, *Collateralized Deferred Compensation — Poison or Panacea*, 20 J. AM. SOC'Y C.L.U. 37 (1966).

In drafting the agreement, it would be possible to expressly limit consultative services to less than 45 hours per month and to allow the executive freedom to choose his own time and place for doing the consultative work and/or provide for additional payments on an hourly basis for consultative services actually rendered.

¹⁰⁶ See generally Kramer, *Employee Benefits and Federal Estate and Gift Taxes*, 1959 DUKE L.J. 341; Weinberg, *Taxation of Non-Qualified Deferred Compensation Plans*, 52 KY. L.J. 750 (1964); Note, *Estate Taxation of Employee Death Benefits*, 66 YALE L.J. 1217 (1957).

¹⁰⁷ Rivers, *supra* note 105; Stoeber, *New Look at Non-Qualified Deferred Compensation Plans*, 19 J. AM. SOC'Y C.L.U. 224 (1965).

the retirement benefits payable to someone other than a surviving spouse or a marital deduction trust, such as a nonmarital trust.

(8) *Gift Tax.* —Where an employee has a *nonforfeitable* right to future payments and he makes an *irrevocable* designation of a person to receive them, he has probably made a completed gift,¹⁰⁸ the value of which will require some actuarial computations.¹⁰⁹ Of course, the actual receipt of payments by a beneficiary during the employee's lifetime results in a taxable gift.

IV. DRAFTING THE APPROPRIATE DOCUMENTS

A. *General Considerations*

In preparing deferred compensation contracts, it should be kept in mind that most of them are basically nothing more than an employment agreement with part of the compensation to be paid after the services are rendered. Tax factors are important, but they should not exclude attention to the general business considerations involved. In drafting any employment contract, including a deferred compensation agreement, the following should be considered:

(1) The agreement should clearly recite that the company employs the employee and the employee accepts the employment with the company for a specific term beginning on a certain date and ending on a certain date. Consideration should be given to whether the employee is obligated to retire at a certain time or whether, if the circumstances warrant, the agreement can be modified so that the employee continues to work on a full-time or part-time basis for the company with a corresponding alteration being made in the provisions for the payment of the deferred part of the compensation. For example, the employee may be extremely valuable to the company but may have declining health. It may be advantageous to provide for a primary term of employment, being a relatively short period in which he continues his present duties while the company endeavors to find a potential replacement, and for which the employee is paid his regular salary; a secondary term of employment in which the employee works part time, training the replacement and supervising important work, and receiving a reduced compensation; and finally, a retirement period in which

¹⁰⁸ See Treas. Reg. § 25.2511-1(h)(10) (1966).

¹⁰⁹ CODE § 2503(b). It should be kept in mind that gifts of a future interest do not qualify for the \$3,000 annual gift tax exclusion.

the employee completely retires and receives the deferred compensation benefits.

(2) The duties of the employee should be delineated to the maximum extent possible. If the employee is to hold an office of the company or to serve on its board of directors, the agreement should state whether he will receive additional compensation for these services. The employee's authority should be fairly specific. For instance, the agreement can contain a preliminary recital that the employee's authority shall be that usually exercised by an executive occupying a comparable position in a company of comparable size and in the same nature of business. The agreement can then specify what his authority shall include, but not be limited to, and recite any specific authority which the employee is to have, such as the establishment of operating, sales, and administrative policies of the company, and the hiring, firing, and determination of compensation of personnel.

(3) The executive's rights in the event the business is sold should be spelled out.¹¹⁰

(4) The agreement should contain provisions for what will occur if the executive dies either during the term of the actual employment or after retirement.

(5) Provisions should also be made for what will occur on the disability of the executive either during the term of the actual employment or after retirement.¹¹¹

(6) Any limits on the executive's authority to incur expenses on behalf of the company should be stated. Also, in light of Internal Revenue Service requirements, it is advisable to provide that the employee shall furnish detailed accounts and receipts for expenses which are reimbursed.¹¹²

(7) It should be stated whether the employee is to be covered

¹¹⁰ "Sale" should probably be defined to include

(a) the sale by the Employer of substantially all of its assets to a single purchaser or to a group of associated purchasers; (b) the sale, exchange, or other disposition, in one transaction, of two-thirds of the outstanding capital stock of the Employer; (c) a bona fide decision by the Employer to terminate its business and liquidate its assets; or (d) the merger or consolidation of the employer in a transaction in which the stockholders of the employer receive less than fifty percent of the outstanding voting stock of the new or continuing corporation. 5 J. RABKIN & M. JOHNSON, CURRENT LEGAL FORMS, form no. 12.01, ch. 12, at 25 (1967).

¹¹¹ It is especially important to provide an adequate definition for the term "disability." *Id.*, ch. 12, contains some examples.

¹¹² Treas. Reg. § 1.162-17 (1958), T.D. 6630, 1962-1 CUM. BULL. 21, discusses income tax treatment of these amounts.

by additional benefits provided by the company for other employees, such as hospital insurance or group life insurance.

(8) Consideration should generally be given to the insertion of some type of restrictive covenant in the contract. Basically, such covenants are of two types: one prohibits the executive from engaging in competitive activity during the full-time employment or a short period thereafter, and the other limits the ability of the executive to engage in any form of competition during his retirement period. It is important for the covenant not to be too extensive in this respect, because in order for a restrictive covenant to be enforceable it must be reasonable.¹¹³ Usually, the covenant is considered to be either entirely reasonable or entirely unreasonable and if it is deemed to be the latter, it is completely unenforceable.¹¹⁴ The restrictive covenant should be tailored to the particular situation so that the maximum enforceable restrictions are achieved. The basic problems will be: (1) defining the business of the employer and stating exactly in what activities the employee is prohibited from engaging, (2) defining the limitations as to *area*, and (3) defining the limitations as to *time*. Most of the cases in this area involve covenants of employees who later attempt to find other employment; few cases involve competition by a person who is supposed to be retired. It is believed that this basic fundamental difference could be used to distinguish most of the existing authority in an attempt to validate a restriction which, on its surface, would seem unreasonable if applied to a person who would be deprived of his method of earning a livelihood if it were enforced.¹¹⁵

(9) In drafting an agreement, consideration should be given to an arbitration clause.

(10) The agreement should probably prohibit the assignment

¹¹³ One of the most important factors in determining the reasonableness of any given restriction is the *necessity* of the restriction for the employer's business. The covenant should do as much as possible to recite why it is necessary.

¹¹⁴ Ohio follows the so-called "blue pencil" doctrine which can save part of a restriction if only part is unreasonable. However, in order for the court to apply this doctrine and strike out the unreasonable portion, the provisions must be *separable*. See *Extine v. Williamson Midwest Co.*, 176 Ohio St. 403, 200 N.E.2d 297 (1964); *Briggs v. Butler*, 140 Ohio St. 499, 45 N.E.2d 757 (1942); *E.P.I. of Cleveland, Inc. v. Basler*, 12 Ohio App. 2d 16, 230 N.E.2d 552 (1967); *Conforming Matrix Corp. v. Faber*, 104 Ohio App. 8, 146 N.E.2d 447 (1959); *Toulmin v. Becker*, 124 N.E.2d 778 (Ohio Ct. App. 1954); *Segal v. Fleischer*, 93 Ohio App. 315, 113 N.E.2d 608 (1952); *Gates-McDonald Co. v. McQuilkin*, 34 N.E.2d 443 (Ohio Ct. App. 1941); *Skyland Broadcasting Corp. v. Hamby*, 141 N.E.2d 783 (Ohio C.P. 1957); *Arthur Murray Dance Studio v. Witter*, 105 N.E.2d 685 (Ohio C.P. 1952).

¹¹⁵ G.T. WASHINGTON & V. ROTHSCHILD, *supra* note 105, at 116.

of the benefits payable thereunder for the convenience of the company and for the tax advantage of the employee.¹¹⁶

(11) It is important to define all terms which may cause a dispute in the document. The words "disability" and "profit" are particularly susceptible to dispute.

(12) If the executive is to receive other fringe benefits, such as paid vacations, company-owned and maintained automobiles, and club memberships, these should be specifically included in the employment contract.

(13) General considerations. The employment agreement should usually contain the general "boiler plate" provisions including a clause pertaining to the giving of notices, a waiver of breach clause stating that the waiver by the company of a breach of any provision of the agreement by the executive does not operate as a waiver of any subsequent breach by the executive. It should also contain a clause reciting that the instrument contains the entire agreement between the parties and may not be changed orally, but only by agreement in writing signed by the party against whom enforcement of any waiver, change, modification, or discharge is sought.

B. Special Problems

In addition to the above general considerations, a deferred compensation agreement raises some special problems, such as (1) the amounts and method of computation of the deferred compensation, (2) the method of payment of the deferred portion of the compensation, and (3) conditions as to the receipt of the compensation both during employment and during retirement.

(1) *Computation of the Amounts To Be Paid.* —Once the total amount of the employee's compensation is decided upon, it must be determined how much is to be deferred. One of the simplest and most direct methods is to provide that the employee will receive a certain fixed salary, a certain fixed part of which is to be

¹¹⁶ The draftsman should observe the general laws governing the validity of restraints on alienation. A restriction which is certainly invalid under State law might not achieve the necessary objective for tax purposes. The Ohio law on this point is not particularly clear. The case of *Sherrow v. Brookover*, 174 Ohio St. 310, 189 N.E.2d 90 (1963), held that a straight spendthrift provision in a trust was invalid. The "straight" spendthrift provision merely states in effect that the beneficiary's interest is not subject to the claims of creditors. The *Sherrow* case did not determine the validity of the beneficiary's *voluntary* alienation nor the validity of forfeiture or discretionary trusts. Appropriate caution should be observed in relying on cases dealing with *trusts* in the *unfunded* deferred compensation areas.

paid currently and a certain fixed part of which is to be paid to him at certain future times specified in the agreement, usually after retirement. A provision of this type can be presented in a narrative form or a table can be provided showing the amount of compensation payable each year, the amount deferred, and when the deferred amount will be paid. The contract can provide for a constant or increasing salary and for uniform or varying percentages of that salary to be paid currently and the remainder to be deferred. The deferred amount can be expressed as a percentage of the salary for the year of employment or, if the employment is to be for more than one year, it can be expressed as a percentage of the average annual compensation over the term or a percentage of the last year's compensation. The compensation, both immediate and deferred, can be made subject to the current profits of the company during the employment period.¹¹⁷ In unique situations, the compensation can be based on the company's billing, gross receipts, or return on net worth.

The amounts payable to the employee can be reduced by a certain amount or by a certain percentage if the employee has other income from other sources. The reduction can follow a certain schedule whereby most of the amounts are to be paid if the employee's other compensation is small and small amounts are to be paid if the employee has substantial other income.

The amounts paid can be made subject to adjustment to reflect inflation, but this adds considerable complexity to an agreement which otherwise can be quite simple.¹¹⁸

(2) *Method of Payment — To Whom and How Much.* — Deferred compensation can be paid in two basic methods. The first method is to pay the employee a fixed amount over a fixed period of time according to a fixed formula. Second is the annuity method in which amounts are paid to the employee for the duration of his life. There are innumerable combinations and variations of these two basic methods. For instance, the benefits can be paid in the form of a joint and survivorship annuity or annuities with a certain number of guaranteed payments or a payment of a

¹¹⁷ The methods for computing the profits are almost limitless. For ideas, see J. RABKIN & M. JOHNSON, *supra* note 110, ch. 12.

¹¹⁸ This could be done, for example, by gearing the payments to the consumer price index or to raises given to other executives (especially if the company gives cost of living increases). The payments could be geared to the value of the company stock, or other stock market indexes, but this would be likely to cause too much variance. Cornfield, *Executive Deferred Compensation*, 36 TAXES 557 (1958), contains a discussion of how to have contracts reflect inflationary pressures.

certain amount to the employee for the duration of his life and thereafter a payment of a certain lesser amount to the employee's spouse or other beneficiary for the duration of her life.

If an annuity form of payment is used, the employer may not want to take the risk of the unknown factor of the employee's life expectancy, and therefore, it will probably want to buy an annuity from a life insurance company so as to fix the liability. The employer will not face a significant tax risk if it buys an annuity on his employee's life with itself as the owner and beneficiary. It should not be done by simply buying an annuity for the employee because this would result in adverse tax consequences.¹¹⁹

Benefits may be paid to a person other than the employee, but if the employee is living at the time of any payment, that payment will be includible in the employee's gross income under the assignment of income doctrine.

Generally, if the plan calls for a fixed number of payments, it will also provide for the payment of any installments unpaid at the employee's death to his estate or to his beneficiary. The beneficiary can be designated in the plan by a fixed formula,¹²⁰ or the employee can be given the right to designate the beneficiary by his will or any designation of beneficiary form supplied by the employer.¹²¹ The plan should probably provide for a payee in default of the employee's designation.

Some deferred compensation plans provide for the payment of death benefits unrelated to the deferred compensation earned by

¹¹⁹ 20-2d T.M. PORTFOLIO, *supra* note 1, at 38; Robinson, *Deferred Compensation in Reverse, Tax and Practical Advantages of Insured Plan*, 99 TRUST & ESTATES 92 (1960).

¹²⁰ The plan could simply state that the death benefits will be paid initially to the spouse of the executive if living at the time of death of the executive or to the children of the executive per stirpes, if the spouse is not living.

¹²¹ Since the beneficiary is to receive an interest in the accumulated fund only upon the death of the employee, it might be argued that the designation of the beneficiary is a testamentary disposition which must comply with the formalities required of a will. However, because the beneficiary under a retirement plan acquires his interest by contract in the same manner as the beneficiary of a regular life insurance policy, the plan designation should be considered a nontestamentary will substitute. See 1 PAGE, THE LAW OF WILLS § 6.1 (Bowe-Parker rev. ed. 1960). In most of the few cases that have considered the problem, the right of the designated beneficiary of a deceased employee who had participated in a pension or retirement plan to take by the terms of the plan has been upheld. See, e.g., *Rogers v. Rogers*, 152 So. 2d (Fla. App. 1963) (public plan); *Buehler v. Buehler*, 323 S.W.2d 67 (Tex. Civ. App. 1959) (private plan); *In re Koss' Estate*, 106 N.J. Eq. 323, 150 A. 360 (1930) (private stock-purchase plan). In New York, it is expressly provided by statute that the designation of a beneficiary under a pension, profit-sharing, or other specified plan "shall not be impaired or defeated by any statute or rule of law governing the transfer of property by will, gift or intestacy." N.Y. ESTATES, POWERS & TRUSTS LAW art. 13, § 3.2(a) (McKinney 1967).

the employee as of the time of his death. This may be thought to be incompatible with the basic concept of deferred compensation agreements calling for a delayed payment of amounts which would otherwise be paid as current compensation; however, these death benefits are frequently included and in some cases serve extremely useful functions. The function of the special death benefit is, of course, to enlarge the estate and provide for the beneficiaries of the employee whose estate is inadequate and who has not accumulated sufficient normal benefits for his survivors under other employee benefit plans. If the death benefit is substantial, the risk of the premature death of the employee makes it extremely advisable for the employer to purchase life insurance on the employee's life. The advantage of providing special death benefits through the deferred compensation plan rather than through the purchase of life insurance for the employee is that the premiums of the latter would be includible in his gross income. The disadvantage is that the death benefits would be taxable income in respect of a decedent to the recipient subject to a possible \$5,000 exclusion whereas the proceeds of a life insurance policy owned by the employee would not.¹²² For this reason, deferred compensation death benefits, if at all substantial, should be paid in installments.

(a) *Investment Accounts.* —Another possible way of computing and providing amounts for payment as deferred compensation to an employee is the use of an investment account. Under this method, funds are actually set aside by the corporation in a separate account, which are then invested in securities or other investments. The securities are usually of the type traded on a stock exchange rather than securities of the company itself. The taxes on the income generated by this account will be paid by the corporation because the funds necessarily must be in the name of the corporation, but they will be charged to the account, thereby reducing it by the extra taxes. At retirement, the employee then receives the increase in value of the fund. There has been some criticism of this type of plan on the grounds that it is illogical. The employee's compensation is not based on the performance of the company for which he is working; rather, it is based on the performance of such stocks as have been purchased for the fund. However, this type of arrangement is generally used only for highly paid employees of fairly large corporations who already have large blocs of stock in the company for which they work. It is believed

¹²² CODE § 101(b).

that this type of arrangement allows for investment diversification and therefore benefits the employee, making it not at all illogical. If the investment account device is employed in the proper situation where the employee already has a large bloc of stock in the employer-corporation and is therefore sufficiently motivated to use his best efforts to see to the success of that corporation, there is no logical reason why the company should not give him compensation in the form of securities of other corporations so that his investments are diversified.

(b) *Shadow Stock Plans.* —Another method to compute amounts payable to an employee as a form of deferred compensation is the "shadow stock plan." Under this type of arrangement, the employee is granted a number of "units" of participation, each unit being the theoretical equivalent of a share of stock in the company and having assigned to it a value equal to the fair market value of the stock at the time it is awarded. From time to time thereafter the account is credited with so-called dividend equivalents on each unit of participation which are equal to the dividends paid on the actual shares of stock. When the plan terminates, the employee receives the appreciation, if any, in the value of a comparable number of shares of stock between the date the units were credited to him and the date of termination and, in addition, he receives the dividend equivalents previously credited to him. Thus, the employee is given the benefits of dividends on the stock and the appreciation in value of the stock without actually owning any stock. Shadow stock plans can become quite complex and have innumerable variations.¹²³

(3) *Conditions As to the Receipt of the Compensation Both During Employment and During Retirement.* —The employee's right to receive the compensation provided for in the deferred compensation agreement can be made subject to two sets of conditions — preretirement conditions and postretirement conditions.

It is sometimes advisable from a business point of view to have a provision in the deferred compensation agreement to the effect that the compensation provided for by the agreement will be received by the employee only while he is employed by the company or only after his employment is terminated under certain circumstances. Generally, these circumstances are retirement, death or

¹²³ See Shelmerdine, *Shadow Stock Deferred Compensation Arrangements*, N.Y.U. 17TH INST. ON FED. TAX. 933 (1959); *Phantom Stock Plans; An Increasingly Popular Form of Executive Compensation*, 22 J. TAXATION 342 (1965).

disability, termination by the corporation for any reason other than dishonesty or wrongful conduct on the part of the employee, and termination as a result of other circumstances which are not deemed by the board of directors of the corporation to be prejudicial to the interests of the corporation.

As an alternative drafting technique, it can be provided that, if the employee's employment is terminated for any reasons such as discharge for dishonesty, insubordination, or destruction of company property, the unpaid amounts called for by the deferred compensation agreement shall be forfeited.

The retirement payments can also be made subject to certain postretirement conditions. Some possible conditions are that the employee shall render consultative services and/or serve on the board of directors, refrain from competing with the company, refrain from disclosing to unauthorized persons information relative to the business of the corporation, the disclosure of which might be harmful to the company, and refrain from acting in a manner which the employer shall have reason to believe is detrimental or contrary to the best interests of the corporation.

Sometimes it is advisable to provide that a valued employee who has accumulated a great deal of knowledge and experience should hold himself open to render consultative services to the corporation after his retirement. However, if the consultative services called for, or those actually rendered, are substantial in nature, this may cause the continuance of the employment relationship for social security purposes, withholding tax purposes, and for purposes of the regular qualified deferred compensation plans. For this reason, unless it is actually contemplated that some consultative services will be rendered and unless the employee actually has some beneficial knowledge and ability which the corporation could use after his retirement, a provision for consultative services should probably be omitted.¹²⁴ As mentioned earlier, an agreement not to compete must be reasonable and its reasonableness must be determined by reference to the conditions of the industry, to the conditions of the company, to the position of the employee giving the agreement, and to the local law.¹²⁵

If the employee will probably have confidential information,

¹²⁴ For an argument that contingencies are still advisable in deferred compensation contracts even after Revenue Ruling 60-31, see Appert, *Contingencies in Deferred Compensation Arrangements May Still Be a Wise Precaution*, 13 J. TAXATION 12 (1960).

¹²⁵ For a summary of the law in Ohio, see cases cited note 114 *supra*.

it would be a good idea to provide as a postretirement condition that he should not disclose this information to others. This gives the company a practical method of enforcing the particular provision by simply cutting off the payments. In addition, if the disclosure provisions are fair and reasonable, they can probably extend and clarify the substantive content of the general law involving disclosure of trade secrets.

The effect of contingencies in deferred compensation arrangements has been recently discussed in Revenue Ruling 67-449. In that ruling, the Internal Revenue Service approved a nonqualified deferred compensation plan which gave the employee some choice as to the amounts and years of payment of the installments. The apparent key to the approval of that plan was the substantial forfeiture provisions contained therein, and it has been indicated that this might foreshadow IRS insistence that contingencies must be included in all deferred compensation plans.¹²⁶ Revenue Ruling 67-449 did not mention Revenue Ruling 60-31, so it is difficult to put the two rulings in overall perspective. However, it would appear that there is a basic distinction between plans of the type set forth in Revenue Ruling 60-31, which called for payments at specific times, and the plan presented in Revenue Ruling 67-449, which allowed the employee an election both as to the times of payment and the amounts of each payment. It would seem clear that contingencies are still not required in the "60-31-type" plans, but that substantial forfeiture provisions are required in "67-449-type" plans, which allow the employee after the services have been performed and the amounts of payment ascertained, to elect both when and in what amounts the deferred payments will be made. The problem left for future resolution concerns the middle ground between the two extremes. For example, it is not clear whether forfeiture provisions are necessary in plans which would allow elections, but only *before* the amount is ascertained and *before* substantially all of the services have been rendered.¹²⁷

¹²⁶ See Lurie, *The Problems Created by IRS New Stress on Contingencies in Non-qualified Plans*, 28 J. TAXATION 258 (1968).

¹²⁷ The "earning out" language of Revenue Ruling 67-449 is unique. "Earning out" is apparently synonymous with satisfaction of all of the conditions contained in the plan, but the term can be susceptible to a greater meaning. "Earning out" could mean the performance by the employee of overt acts which constitute a benefit to the employee, as opposed to merely refraining from doing certain things detrimental to the employer. The exact meaning of "earning out" will be left for future determination. The phrase may become important in drafting plans allowing elections by the employee.

V. CONCLUSION

Deferred compensation arrangements are an important part of the employee compensation picture. In examining any particular situation, the first step must be the analysis of the entire compensation framework. Current compensation, the more traditional fringe benefits, and the tax-favored qualified plans should be considered. The second step of the examination should be to make a careful, thorough analysis of the net economic effect of the deferral of some portion of compensation. If the first and second steps indicate that a deferred compensation arrangement would be advantageous, the third step will be the determination of the type of plan best suited for the particular situation, in light of the objectives and tax rules discussed above. Once the basic type of plan is decided upon, the appropriate documents must be drawn. Generally, the document should take the form of an employment contract with special provisions dealing with the retirement of the employee and the deferred payments. In most cases, the arrangement should be unfunded with the employee's rights to the deferred payment forfeitable at least until retirement. Provisions calling for consultative services should be included only after careful consideration of the problems they cause. The agreement should prohibit direct competition after retirement, and if the plan permits any type of election, substantial forfeiture provisions should be considered, not only until retirement but after retirement until the actual compensation is received.